

Commentary by Douglas R. Andrew on

The Tradeoff between Mortgage Prepayments and Tax-Deferred Retirement Savings From the Working Papers of the Federal Reserve Bank of Chicago

By Gene Amromin, Jennifer Huang, and Clemens Sialm,

One of our own federal banks—Chicago's Federal Reserve Bank—has determined that by accelerating mortgage payments instead of stashing money in tax-deferred accounts, more than one in three Americans are making the "*wrong choice*," and are giving up potentially important arbitrage gains.

The mortgage overpayments, the Fed's recent report says, is a "mis-allocation" of funds that costs people \$1.5-billion a year. If consumers changed their allocation by *not* sending excess payments to their mortgage company, and instead put that money in some form of tax-advantaged savings, they would reap a median gain of between 11 and 17 cents per dollar.

This is the *very first time* the Fed has compared these two kinds of "savings," write the authors. They conclude that "many households have significant amount of money" in both tax-favored and taxable accounts, but that a "large proportion" of American taxpayers apparently are *not* taking the smarter route to asset allocation, which would put substantially more money in their retirement savings.

I am delighted to see that the Fed's own experts now believe deductible mortgage interest can be an excellent choice for many taxpayers to use in structuring their retirement funding strategy, even though I do not agree with the report's narrow focus on only qualified plans such as IRAs and 401(k)s.

What's more, the paper says arbitrage is a "rather conservative" way of optimizing retirement wealth. Taxpayers gain when interest rates go up, since the newly invested amount earns higher rates than the mortgage debt costs. Should interest rates go down, taxpayers still come out ahead, because they are "likely to exercise their option to refinance," thus "reducing the downside risk of the arbitrage strategy."

The Fed report ends by saying that despite the risks (and remember—there are risks associated with all investment strategies), saving retirement money in a tax-deferred plan "has the additional benefit of providing a good hedge against the combination of housing price risk and liquidity risk."

Finally, the Fed says that taxpayers with incomes over \$100,000 a year who use mortgage-deductible interest as part of an arbitrage strategy in retirement accounts would appear to have the most to gain, and the authors find it "puzzling" that more people who are in "better financial shape" than the average taxpayer don't take advantage of this kind of strategy.

I have no idea if the authors of this Federal Reserve paper have read my *Missed Fortune* books or have heard of me. But it is gratifying to see government experts themselves validate and support a key element of my wealth optimization program. If you would like to read the entire study, it is available at www.MissedFortune.com/ChicagoFedStudy as found in the "working papers" section of the Federal Reserve Bank of Chicago's Web site.

The study also points out that:

- "46.1 percent of households are prepaying their mortgage by an average of \$3,140 per year"
- "only 49 percent of households relied on advice from professionals"
- "having access to better financial information (financial advisor or personal education) substantially increases the likelihood of making the right choice"

The key reasons Americans make these mistakes are:

- "not having resources to make decisions"
- "greater emphasis on savings habits they 'perceive' as more liquid"
- "limited information on the cost-benefit analysis"
- "rational response to 'institutional' factors"

The actual quote from the abstract at the beginning of the report reads as follows:

“We show that a significant number of households can perform a tax arbitrage by cutting back on their additional mortgage payments and increasing their contributions to tax-deferred accounts. Using data from the Survey of Consumer Finances, we show that about 38% of U.S. households that are accelerating their mortgage payments instead of saving in tax-deferred accounts are making the wrong choice. For these households, reallocating their savings can yield a mean benefit of 11 to 17 cents per dollar, depending on the choice of investment assets in the tax deferred accounts. In the aggregate, these misallocated savings are costing U.S. households as much as 1.5 billion dollars per year...”